

# 11.03 Finance Leases – Lessee Accounting

## Overview

A **finance lease** is generally one in which the rights and risks of ownership have essentially transferred from the lessor to the lessee. That is, in substance it's a purchase, although in form it's a lease. Just as with an operating lease, the lessee recognizes both a right-of-use asset and a liability at the PV of the lease payments.

While an operating lease liability would generally not be considered debt for purposes of ratios, debt covenants, etc., a finance lease liability is considered part of the lessee's total debt—eg, it is part of "Debt" in the Debt-to-Equity ratio. Another key difference is that the right-of-use asset will normally be amortized on a S/L basis, not unevenly as with an operating lease.

Note: The lessor will account for a finance lease as a sales-type lease, either with or without profit (discussed in another section).

	Finance Lease	Operating Lease
Lessee recognizes:	Right-of-use asset and Lease liability at PV of payments	
Part of lessee's debt for purposes of ratios, debt covenants, etc.?	Yes	Generally not
Right-of-use asset is amortized:	Generally on straight-line basis	Unevenly*

\* Over term of lease for difference between total lease expense and accrued interest for each period

## Finance Lease Criteria

If the lease meets one of the following five criteria (**Special-PO-T-75-90**), the lessee accounts for the lease as a finance lease, as if he *owns* it. If not, it is considered an operating lease.

1. Due to its **Specialized nature**, the leased property has no foreseeable alternative use to the lessor at the end of the lease term.
2. The lease contains a "**Purchase Option reasonably certain to be exercised.**"
3. The lease **transfers Title, ie, ownership**, of the property to the lessee by the end of the lease term.
4. The lease term is for the "**major part**" (**75%**) of the remaining economic life of the property. ASC 842 suggests 75% or more of the estimated economic life of the property at inception as meeting this "major part" criterion; however, this is no longer a bright-line test.\*
5. The PV of lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments is equal to "**substantially all**" (**90%**) of the FMV of the property

at inception. ASC 842 suggests 90% of FMV as meeting this "substantially all" criterion; however, this is no longer a bright-line test.\*

\*If the beginning of the lease term falls "at or near the end" of the estimated economic life of the leased property, criterion #4 and #5 cannot be used for purposes of classifying the lease. ASC 842 suggests within the **last 25%** of the economic life as a reasonable guideline for assessing the property to be "at or near the end" of its useful life.

## Recognition

After the commencement date, the lessee will report **interest expense** on the liability and **amortization of the right-of-use asset** (generally on a *S/L basis* unless another basis is more representative of the lessee's consumption pattern) in the income statement.

- The lessee must amortize the right-of-use asset over the **shorter of the useful life or the lease term**, unless there is a purchase option that is reasonably certain to be exercised (PO) or the title transfers at the end of the lease (T). When this is the case, the property is amortized over the useful life of the asset even if it is longer. This same rule applies to **leasehold improvements** under a finance lease.
- Variable lease payments that are not already included in the lease liability are expensed as incurred.

## Examples

Now, let's take the same example we used for operating leases, except that the economic useful life of the equipment is 5 years instead of 10. Since the lease consumes 100% of the economic useful life of the asset, the lease must be accounted for as a finance lease.

- To reiterate, assume the client has signed a 5-year rental contract for office equipment on 1/1/Year 1.
- The client has an incremental borrowing rate of 6% and the payments are \$10,000 per year, due at the end of each year.
- As an inducement to enter the agreement, the client has been offered the first six months free and a \$1,000 signing bonus.
- The lessee has incurred \$1,000 in initial direct costs.
- The PV factor for a lump sum at 6% for 1 year is 0.943, and the PV factor for an ordinary annuity at 6% for 5 years is 4.212.

In Year 1, the initial entry is the same (\$37,405 PV of \$45,000 in lease payments - \$1,000 bonus + \$1,000 initial direct costs):

Right-of-Use Asset	37,405
Lease Liability	37,405

The accounting changes when we get to the recognition of lease expense, which must be reported separately as **interest expense** and **amortization expense** (which is generally reported on a S/L basis) in the income statement. Thus, for the first year, the entries will be as follows at 12/31/Year 1:

Amortization Expense	7,481
Right-of-Use Asset*	7,481
Interest Expense**	2,244
Lease Liability	2,756
Cash	5,000

- \*Right-of-Use Asset is reduced for the amount amortized (ie, S/L over 5 years):  $\$37,405 / 5 = \$7,481$
- \*\*Interest expense is  $6\% \times \$37,405$ , or \$2,244 and Lease Liability is reduced to \$34,649 for the difference between the payment and the interest expense (ie,  $\$5,000 - \$2,244$ , or \$2,756).

Entries at 12/31/Year 2:

Amortization Expense	7,481
Right-of-Use Asset*	7,481
Interest Expense**	2,079
Lease Liability	7,921
Cash	10,000

- \*Right-of-Use Asset is reduced for the amount amortized (ie, S/L over 5 years):  $\$37,405 / 5 = \$7,481$ .
- \*\*Interest expense is  $6\% \times \$34,649$  lease balance, or \$2,079, and Lease Liability is reduced for the difference between the payment and the interest expense (ie,  $\$10,000 - \$2,079$ , or \$7,921).

Let's do another example to see how the calculations and entries change when the first payment is made on day 1. In this case, the entire first payment reduces the lease liability. Remember: when the first payment is made at year end, that payment will include interest expense.

Assume the client has signed an 8-year equipment lease with payments of \$75,000 per year, due at the beginning of the year. The estimated economic life of the equipment is 10 years. The depreciation method is straight-line, and there is no residual value. Title to the equipment passes at the end of the lease. The lessee's incremental borrowing rate is 12%, but the lessor has made it known to the lessee that the rate implicit in the lease is 11%.

Since the 1<sup>st</sup> payment of \$75,000 is due on day 1 (ie, annuity due), the PV of the 8 lease payments @ 11% (5.7122 PV factor) = \$428,415.

Lease Liability	Interest Rate	=	Accrued Interest Expense	-	Lease Payment	=	Reduction in Lease Liability
428,415					75,000		75,000
(75,000)							
353,415	11%	=	38,876	-	75,000	=	36,124
(36,124)							
317,291	11%	=	34,902	-	75,000	=	40,098
(40,098)							
277,193							

Initial entry to record the asset and lease liability at PV of lease payments (note that there are no other payments or initial direct costs in this example):

Right-of-Use Asset	428,415	
Lease Liability		428,415

First Payment at 1/1/Year 1:

Lease Liability	75,000	
Cash		75,000

Amortization at 12/31/Year 1 (428,415 / 10-year useful life since title transfers at end of lease):

Amortization expense	42,842	
Right-of-Use Asset		42,842

**Interest accrued from first payment to 12/31/Year 1** ( $353,415 \text{ lease liability} \times 11\% \text{ interest rate}$ )

Interest expense	38,876	
Interest payable		38,876

**Second Payment at 1/1/Year 2:**

Lease Liability	36,124	
Interest payable	38,876	
Cash		75,000

*Note: Of the remaining \$317,291 Lease Liability at the end of Year 2, the next payment of \$40,098 represents a current liability (ie, due within 1 year) and the rest (\$277,193) is a long-term liability.*